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Puerto Rico Utility Deal Stumbles, Shaking Muni Investors.

Municipal bondholders turned bullish on Puerto Rico's troubled utility just as elected officials vetoed a politically unpopular repayment plan

Municipal bond buyers thought Puerto Rico was on the cusp of restructuring its troubled power monopoly on their preferred terms. Now they aren't so sure, as government leaders harden their stance against hiking electricity rates to pay off billions of dollars in debt.

Some of the municipal bond market's largest investors, including BlackRock Inc. and MacKay Shields LLC, have accumulated hundreds of millions of dollars in claims against the Puerto Rico Electric Power Authority, the public electric monopoly known as Prepa, people familiar with the matter said. They largely have replaced hedge-fund managers that wound down trades on Prepa after several years navigating its bankruptcy, according to court records and the people familiar with the matter.

Market-leading bond managers have been wary of Puerto Rico for several years while its finances deteriorated and it entered a court-supervised bankruptcy proceeding in 2017. Much of the U.S. territory's debt has been held in hedge funds that bought bonds at discounts in the hopes of producing double-digit returns.

But Prepa became more attractive to municipal investors last year when it won broad creditor support to repay $8.3 billion in power revenue bonds at no less than 67.5 cents on the dollar, while raising electricity rates to cover settlement payouts. The restructuring proposal required court approval and the cooperation of Puerto Rico's elected leaders to take effect.

Investors turned bullish on Prepa, betting politicians would favor lifting a crown-jewel public asset out of bankruptcy even if electricity bills went up.

BlackRock has bought more than $800 million in Prepa bonds since the proposed terms were announced, a person familiar with the matter said. Nuveen Asset Management LLC, the biggest player in high-yield municipal funds, also bought $840 million in Prepa bonds, according to court documents. Hedge funds including Silver Point Capital LP and Knighthead Capital Management LLC sold down their positions.

The turnover among Prepa's investors came as municipal bondholders generally sought out less creditworthy borrowers to generate returns as bond yields, which move in the opposite direction as prices, hit their lowest levels in decades.

But in recent weeks, political leaders including Puerto Rico Gov. Wanda Vázquez and Senate President Thomas Rivera Schatz have all but vetoed the proposed deal and taken an increasingly populist stance against debt repayment. They said they wouldn't accept any hikes in electricity rates, as bondholders have required.

Manufacturers that are some of Prepa's largest clients also are lobbying against any rate increase, citing the impact on corporate budgets. Renewable power companies oppose a provision requiring solar energy users to contribute toward bondholders' repayment.

The oversight board managing Puerto Rico's finances supports the proposed settlement. But without approval from elected leaders, Prepa can't issue new bonds to replace its legacy debts and the restructuring deal can't go into effect, according to people involved in the matter.

Bondholders haven't abandoned the proposed deal in favor of litigation. They have said a rate increase is inevitable and would be several times larger if they win court rulings that require Prepa to repay in full.

Without the debt settlement, Prepa has no clear path out of bankruptcy. The longer it stays under court protection, the longer its bond values will remain depressed.

"It's a combination of bad timing—muni buyers lacking alternative places to steer their high-yield allocations—and maybe a prior lack of understanding of just how unpopular this plan is on the island," said Matt Fabian, a partner with Municipal Market Analytics Inc.

"It's not a hard mistake to make," he added.

Stephen Spencer, a banker advising some of the bondholders, said they are working "constructively and in good faith with the oversight board to build consensus around a path that allows Prepa to emerge from bankruptcy in the coming months."

The stalemate also is impacting attempts to dismantle Prepa's public-monopoly structure. Considered a crown jewel of Puerto Rico's industrialization efforts in the 1940s and 1950s, Prepa became less efficient over time as generators fell into disrepair and it pared back capital investments. It was widely criticized for its response to Hurricane Maria, the 2017 storm that left some residents without power for 11 months and contributed to a death toll of nearly 3,000.

The utility has spent months negotiating a long-term contract that would put private operators in charge of operating and maintaining the power grid. A consortium of operators led by Quanta Services Inc. has been shortlisted as the preferred bidder, according to people familiar with the matter.

In recent weeks, the oversight board has told contract negotiators the debt settlement could collapse and to account for that possibility, some of the people said. Quanta said it couldn't comment, citing a confidentiality agreement.

"I don't see them doing anything definitive until they see what Prepa is ultimately going to look like," said Rick Donner, a project finance analyst at Moody's Investors Service Inc.

A spokesman for the oversight board said ending Prepa's bankruptcy would ease the way for private investment and federal assistance to the electricity system, which sustained severe damage from Hurricane Maria and from more recent earthquakes.

The oversight board said it is trying to convince lawmakers to change their minds while "exploring other options that would allow Prepa to exit bankruptcy and support this transformation."

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